Final 1001 regulations for banks

by Dan Mayo and Rowan Liu

On November 5, 2013, the Treasury Department and IRS issued final regulations[1] that address when a transfer or assignment of derivative contracts does not result in a taxable event to the nonassigning counterparty for purposes of section 1001 and Treasury regulations section 1.1001-1(a). The final regulations adopt the safe harbor approach provided in the temporary regulations that were released in 2011,[2] and clarify that payments made to or from an assigning party will not create a deemed loan under the rules in Treasury regulations section 1.446-3(g)(4) (relating to certain significant nonperiodic payments).

Background

Section 1001 provides rules governing the computation and recognition of gain or loss from a sale, exchange, or other disposition of property. The Treasury regulations promulgated thereunder provide that gain or loss is realized upon an exchange of property for other property differing materially either in kind or in extent.[3] The modification of a contract can be a taxable disposition of the old contract if the modified contract differs materially from the old contract either in kind or in extent.[4] Thus, the assignment of a contract, including many modern derivatives, is generally treated as a taxable disposition to the nonassigning party if the resulting contract differs materially from the original contract either in kind or in extent.[5]

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[6] imposed significant limitations on a bank's proprietary trading activities, which requires, in some instances, that a bank transfer or assign entire books of derivative contracts. Specifically, the "Volcker Rule"[7] prohibits banks from holding more than 3 percent of their Tier One capital in certain securities or derivatives, and the "Swap Push-Out Provision"[8] denies federal deposit insurance and access to the Federal Reserve discount window for any bank that is considered a "swaps entity" (*i.e.*, a swap dealer or major swap participant). As a result, banks were required to transfer or assign significant amounts of their derivatives trading activities to subsidiaries or other entities. Prior to the issuance of the final regulations, the banking community was concerned that such intragroup contract assignments could create taxable events for banking clients as the nonassigning parties.

The regulations

Treasury and the IRS first addressed these concerns in July 2011 with the issuance of temporary regulations. The temporary regulations addressed these concerns by providing that the transfer or assignment of a derivative contract is not treated as a deemed exchange of the contract by the nonassigning party for purposes of Treasury regulations section 1.1001-1(a) if three conditions are satisfied:[9]

- The transfer or assignment is between dealers or clearinghouses
- The terms of the contract permit the transfer or assignment, whether or not the consent of the nonassigning counterparty is required

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[1] T.D. 9639 (November 5, 2013).

[2] T.D. 9538 (July 21, 2011).

[3] Treas. Reg. § 1.1001-1(a).

[4] *See* Rev. Rul. 90-109, 1990-2 C.B. 191 (ruling that a fundamental change to the contract is a disposition under section 1001).

[5] *See Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 566 (1991) (finding properties to be materially different "so long as they embody legally distinct entitlements").

[6] P.L. 111-203 (2010).

[7] Dodd-Frank, § 619.

[8] Dodd-Frank, § 716.

[9] *See* Treas. Reg. § 1.1001-4(a)(1)-(3).

- The terms of the contract are not otherwise modified as to trigger recognition under section 1001.

One of the most important impacts of the temporary regulations was to broaden the safe harbor that existed in the prior regulations (which were issued in 1998). Previously, only dealer-to-dealer transfers of notional principal contracts (NPCs) qualified for the safe harbor; the temporary regulations applied to derivative financial instruments on securities, currencies, or commodities, including options and forward contracts, in addition to NPCs.[10] Further, the temporary regulations expanded the safe harbor to also apply to transfers to and from clearinghouses, not just dealers.

Another important impact of the temporary regulations was to clarify that taxpayers can qualify for the safe harbor in the regulations even if their contracts require the assigning or transferring party to obtain consent from the nonassigning party.

The final regulations issued on November 5, 2013 adopt the language of the temporary regulations without modification and added one additional practical point of interest to the assigning or transferring party. The final regulations provide that, with respect to derivative contracts that qualify as NPCs under Treasury regulations section 1.446-3, any payment between the assignor and the assignee would not constitute an embedded loan under Treasury regulations section 1.446-3(g)(4) as long as the transfer or assignment satisfies the conditions in the final regulations.[11] The Treasury Department and the IRS believe that it would be inconsistent to find an embedded loan from a transfer that does not create a taxable event for the nonassigning counterparty.[12]

Insights

The tax community, including those representing banks, generally was pleased with the expansion in the temporary regulations of the safe harbor for the nonassigning party. The regulations also cleared up the market uncertainty surrounding the issue of whether a contract permitted assignment if consent was required of the nonassigning party. Perhaps this explains why the IRS received no written or electronic comments to the temporary regulations and no public hearing was requested or held. Similarly, the final regulations are welcome news because they adopt wholesale the text of the temporary regulations and provide greater certainty for assigning banks. These final regulations should greatly facilitate regulatory compliance, as well as the movement of derivatives in general, without creating unnecessary tax hurdles.

New York ALJ holds in favor of UniCredit bank in IBF apportionment dispute

by Russell Levitt and Dave Turzewski

In a recent decision, a New York State administrative law judge (ALJ) soundly rejected the audit division's standard approach for curtailing the apportionment benefit offered by the International Banking Facilities (IBF) provisions of the Bank Tax law. (*Matter of UniCredit S.P.A.*, DTA #824103 [November 7, 2013].) Since ALJ decisions are not precedential, the official value of the case will hinge on whether the Division of Taxation maintains a successful appeal with the three-member Tax Appeals Tribunal.

In 1978, the New York State Legislature recognized that New York's international financial stature was facing increasing competition from foreign financial centers such as London. Accordingly, the New York Bank Tax statutes were amended to provide a

[10] *See* Treas. Reg. § 1.1001-4(c).

[11] Treas. Reg. § 1.1001-4(c).

[12] T.D. 9639, *supra*, Preamble.

tax benefit for banks that establish IBFs. As generally defined, an IBF is a separate set of asset and liability accounts segregated on the books and records of the banking entity that has established the IBF.

Initially, the New York IBF tax benefit allowed for the bank to exclude from its New York entire net income (ENI) the income earned by the IBF from its transactions with foreign persons, less direct and indirect expenses attributable to the IBF's operations. This IBF tax benefit is known as the "income modification method." The income modification method effectively treats the IBF as though it and the bank were separate entities.

When the Bank Tax was substantially overhauled in 1985, the Legislature added a second option by which a bank can benefit from maintaining an IBF. This second option is known as the IBF "formula allocation method." Since that time, a bank that has established an IBF has the right to elect on an annual basis between the income modification method and the formula allocation method. Under the formula allocation method, the bank is allowed to subtract from the "New York numerators" of its respective deposits, payroll and receipts apportionment factors, the values which are properly attributable to the IBF's production of "eligible gross income" (basically, income from foreign persons). The formula allocation method effectively treats the IBF as though it were a foreign branch of the bank.

Thus, the income modification method enables the bank to exclude the preapportionment qualifying net income of the IBF from the bank's ENI, whereas the formula allocation method enables the bank to exclude certain apportionment factor numerator values attributable to the IBF.

UniCredit bank elected the formula allocation method benefit for 1999 and 2000. The audit division asserted that the IBF's beneficial relevance to reducing the deposit and payroll factors was overstated, in that a so-called "scaling ratio" was required to be applied to the IBF's deposit and payroll figures. The 1999 and 2000 form instructions did not direct taxpayers to apply a scaling ratio or any other method to reduce IBF deposits to account for ineligible income when applying the formula allocation method. However, the 2003 form instructions were altered to reflect such approach.

The essence of the issue before the ALJ was whether a key principle contained in the regulations that apply to the IBF income modification method could be applied to the formula allocation method as well. The income modification method provides that expenses attributable to the IBF's production of ineligible gross income reduce the amount of income that the bank can carve away from its ENI. Eligible gross income and ineligible gross income are specifically defined in the regulations governing the IBF income modification method. However, the law is silent regarding the use of the definition of ineligible gross income—as provided under the income modification method—for purposes of the IBF formula allocation method.

UniCredit's IBF's books reported both effectively connected income (ECI) and noneffectively connected income (NECI), as well as certain interbranch income. Even though the interbranch and NECI figures were not included in UniCredit's federal taxable income, nor, consequently, in its ENI, the audit division contended that, by definitional default—and its bridging approach—such income must be ineligible gross income, and thus relevant to the application of the scaling ratio. Accordingly, the audit division claimed that the IBF's ratio of eligible gross income to its total income (which included NECI), be used to scale back the reported deposits and payroll factors' benefits (to only 53.5685 percent in 1999, and 60.1147 percent in 2000).

UniCredit claimed that, for purposes of the IBF formula allocation method, it had only eligible gross income and no ineligible gross income. The ALJ agreed. The ALJ conducted a thorough review of the statutes, regulations, audit guidelines, and the official 1986 tax bulletin which provided guidance on the 1985 Bank Tax law changes. According to the ALJ, if the legislature had intended the concept of ineligible gross income be applied to the formula allocation method, it could have placed such a reference in the statute. Because no such reference existed, the ALJ concluded that, relative to the deposits and payroll factors of the IBF formula allocation method, the definition of ineligible gross income contained in the regulations governing the income modification method—and the application of the IBF scale-back ratio—are regulatory provisions that are relevant only for the income modification method, and have no bearing on the formula allocation method.

Furthermore, the ALJ found it especially "compelling" that the NECI was not included in either UniCredit's federal taxable income (per Internal Revenue Code section 882) or in its New York ENI. The NECI was "not income at all for purposes of…[ENI] or [the] formula allocation method," as the ALJ put it and, thus, NECI should not play a role in scaling back the deposits and payroll factors of that method.

Observations:

The ALJ in *UniCredit* deserves praise for displaying the willingness to not accept at face value the audit division's approach to a somewhat complicated apportionment issue. Since its inception in 1986, the ALJs and Tax Appeals Tribunal levels within the New York State Division of Tax Appeals have consistently shown themselves to be fair and impartial arbiters, willing to tackle difficult analytical cases.

The same can be said for their New York City counterparts within the New York City Tax Appeals Tribunal. Indeed, the City's Tax Appeals Tribunal also held in favor of a bank taxpayer on a complicated IBF apportionment issue over a decade ago. Somewhat ironically, that City case—as with the current *UniCredit* case—involved the audit division's unsuccessful attempt to bridge a "disconnect" between the more stringent income modification method and the less stringent (as it was so held) formula allocation method. (*The Park Avenue Bank, N.A.*, TAT[E]99-93 [BT], NYC Tax Appeals Tribunal appellate level [August 6, 2003], *affirming* the Chief ALJ [January 7, 2002].)

As with the State's form instructions introduced in 2003 relative to scaling back ratio for the IBF formula allocation method, the City, in 1999, had published a Statement of Audit Procedure meant to compel bank taxpayers, in another regard, to curtail the statutory benefit offered by the IBF formula allocation method. With the recent *UniCredit* decision, published guidelines have now been equally repudiated as being inconsistent with the governing statutes.

New York corporate franchise tax reform effort

by Russell Levitt and Dave Turzewski

The much prolonged effort to reform the New York general corporation and bank taxes gathered momentum—perhaps the key final push needed for the finish line—with the January 6, 2014 announcement by Governor Andrew M. Cuomo of his plan to reform New York's tax system and to provide tax relief to New York businesses. Although also covering a myriad of taxes, the governor's plan will merge the bank tax into the corporate franchise tax and lower the rate to 6.5 percent.

The governor's proposals apparently were based, at least in part, on recommendations included in the *Final Report* issued by the New York State Tax Reform & Fairness Commission (Tax Reform Commission), a blue-ribbon panel appointed by Governor Cuomo. Issued November 11, 2013, the Tax Reform Commission's Final Report mostly reiterates the reform effort that had stalled after the introduction of a bill in mid-2011.

The governor's proposals also appear to be influenced by the Final Report of the New York State Tax Relief Commission (Tax Relief Commission), which was issued December 10, 2013. While the Tax Reform Commission's recommendations were designed to be revenue neutral, the Tax Relief Commission was charged with the task of developing proposals to provide $2 billion in tax relief to individuals and businesses over the next three years.

The governor's proposals are expected to be included in the Governor's Executive Budget Bill, slated for introduction during the latter half of January 2014. The State Legislature will negotiate the Executive Budget Bill—among themselves and with the governor—with the State's Budget Legislation due to be enacted by April 1, 2014.

Currently, the State's Article 9A tax is substantially the same as when it was enacted in 1944. The State's Article 32 bank tax is substantially the same as when it was enacted in 1985. Officials from the State Tax Department and the Budget Division, along with the Tax Reform Commission, maintain that these tax provisions are out-of-date with the electronic commerce age and, in the case of the bank tax, interstate banking (which was in its infancy in 1985). These officials, along with the Tax Reform Commission, contend that the existing laws make New York an unattractive state, from a corporate tax standpoint, by the inclusion of many unique and complicated rules, including the fact that companies in the same industry can see markedly different tax results depending on which tax article a company applies (as determined by whether or not it is affiliated with a bank).

The Executive Budget Bill also may include some or all of the recommendations of the Tax Reform Commission, including:

- Mandatory unitary combined reporting (thus, banks could be combined with what have heretofore been classified as general business affiliates).
  - A binding seven-year election, to include nonunitary affiliates, would be available.
  - Combined reporting would be based on more than 50 percent affiliated ownership.
  - Alien (non-U.S.) corporate affiliates would be eligible for combination with their U.S. affiliates, but the tax base for an alien corporation would be "water's-edge" U.S. effectively connected income.
- New York's unique "substantial intercorporate transactions" element, which has traditionally dominated the combined reporting analysis, would disappear. Adoption of economic nexus as the nexus standard; although not specifically stated in the Final Report, it is generally believed that nexus would be based on a "bright-line" test such as the level of New York customers or receipts.
- Single factor apportionment based on receipts (as is currently the case for the State's Article 9A tax) and using customer sourcing. *Observation*: This methodology could be a benefit to New York headquartered banks, because their New York deposits and payroll would no longer adversely impact their apportionment.
- Repeal of the financial services investment tax credit. (The Report referred to this credit as being too complex, subject to recapture, and concentrated among too few.)

According to the Tax Reform Commission Final Report, the Commission does not expect all recommendations to be adopted. Instead, it provides a "menu of options within the context of State revenue neutrality." In addition, tax reform may include options not listed in the Final Report, such as provisions that had been part of the 2011 bill, which was not enacted, including:

- The elimination of the Gramm-Leach-Bliley transitional classification rules, as they would be rendered obsolete by the merger of the two tax articles
- The elimination of the concept of subsidiary capital income—currently excluded fully for the Article 9A tax, and in a large percentage for the Article 32 tax
- Substantial curtailment of the scope of investment income—currently, favorably apportioned under Article 9A.

Observations:

A number of uncertainties persist at this point, even assuming that the legislation as outlined above comes to fruition this year.

One question relates to whether the legislation would be effective for tax years beginning on or after January 1, 2014 (*i.e.*, mildly retroactive, by a few months), or for tax years beginning on or after January 1, 2015 or later. While New York tax legislation enacted in the spring is ordinarily retroactive to January of the year, these tax reform measures would be of such a sweeping magnitude that it might make more sense to delay their implementation until the following year. Taxpayers, including those who suddenly find themselves with economic nexus, could be prejudiced by reliance on the existing rules well into 2014, and the State would have to quickly devise and publish new tax forms.

A second question relates to whether New York City would sign on, in tandem, for the new tax regime. The City has, essentially, the same general corporation tax and bank tax regimes as the State. It is well-recognized that nonconformity between the State and City would pose serious complications for corporate taxpayers' compliance efforts, and could be seen as harmful to New York's overall business reputation. In certain past situations, such as with the broker-dealer customer sourcing rules, and combined reporting, the City lagged a number of years behind the State's legislation. Whether history repeats with the tax reform effort remains to be seen.

We will continue to update you on the New York tax reform efforts as they develop.

New deposit interest reporting regulations

by Mark Price and Liz L'Hommedieu – WNT

The impact of the Foreign Account Tax Compliance Act (FATCA) has been well publicized in recent years. With the objective of increasing transparency in offshore accounts held by U.S. taxpayers, it has also brought substantial compliance burdens to our clients. In conjunction with FATCA, the United States has entered into intergovernmental agreements with foreign countries that have the objective of facilitating the exchange of taxpayer information between the countries. These agreements are expected to require the foreign jurisdiction to share information with the IRS to combat offshore tax evasion by U.S. taxpayers in exchange for information that will assist the foreign jurisdiction in combating offshore tax evasion by its residents.[13]

[13] T.D. 9584 (April 19, 2012).

As a means of gathering information on foreign residents, Treasury finalized regulations under section 6049 that will generally require U.S. depository institutions to report to the IRS interest paid to nonresident aliens. Under section 1.6049-4(b)(5), a depository institution is required to file a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding,* with the IRS on certain interest payments of $10 or more to individuals who are neither citizens nor residents of the United States. For this purpose, "interest" means:

- Interest on deposits maintained at an office within the United States
- Paid to a nonresident alien individual who is a resident of a country that is identified as a country with which the United States has in effect an income tax agreement relating to the exchange of tax information.[14]

The IRS plans to periodically release revenue procedures that identify the countries with which an agreement is in effect.[15] The final regulations apply to all payments of interest made on or after January 1, 2013, and the first Forms 1042-S must be filed with the IRS by March 15, 2014. A copy of the Form 1042-S must also be provided to the recipient of the interest payment by March 15.

The Form 1042-S requires the financial institution to identify the name, address, amount earned, and other personal information regarding interest received by each nonresident alien. As can be imagined, implementing the information-gathering procedures is expected to place a significant compliance burden on financial institutions. Prior to the release of the final regulations, there was generally no reporting requirement on interest paid to foreign persons on deposits if the interest was not connected with the conduct of a U.S. trade or business. The one exception was interest payments to Canadian residents. With the new regulations sweeping in essentially all foreign account holders, compliance could require substantial overhauls to banks' policies and core operating systems. Many financial institutions have voiced concern that they currently do not have all the required information that must be included on the Form 1042-S. As a result, these institutions have been required to contact certain foreign account holders to satisfy the disclosure requirements. Notwithstanding the initial commitment to implement the updated procedures around the new compliance requirements, the IRS estimates financial institutions will spend approximately 500 hours annually to comply with these rules.[16]

In addition to the compliance burden, financial institutions are also concerned that the filing requirements may cause customers to move their deposits out of U.S. banks. Opponents of the regulations believe certain foreign governments will use information provided by the IRS in ways other than provided for in the intergovernmental agreements. Bankers associations in Florida and Texas have filed a complaint in the U.S. district court to invalidate the regulations.[17] While Treasury has been outspoken in stating that it will penalize foreign jurisdictions that misuse information, many participants in the financial services industry remain apprehensive of the new rules.

The financial services industry is currently facing significant regulatory reform. While the changes to the deposit interest reporting regulations may receive less publicity than other developments, the regulations require substantial changes to financial institutions core systems and processes, while at the same time creating concerns for a significant number of their account holders.

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[14] Section 1.6049-8(a).

[15] *See* Rev. Proc. 2014-24, 2012-20 I.R.B. 913.

[16] 76 FR 1105-01 (Jan. 7, 2011).

[17] *See Florida Bankers Association et al. v. U.S. Dept. of Treasury* (No. 1:13-cv-0529).

Now is a good time to confirm that financial institutions that may qualify as withholding agents[18] are compliant with the filing requirements associated with the Form 1042-S and Form 1042.[19] KPMG can also assist financial institutions in identifying depositors subject to the new reporting rules, assist in the design of systems to capture and report the required information, review and test the new information reporting processes and systems, and help design governance procedures for ongoing compliance.

IRS issues new IDR guidelines

by Sharon Katz-Pearlman, Wendy Sands, and Justin Donatello

On November 4, 2013, the Internal Revenue Service (the Service or the IRS) issued a directive to Large Business & International (LB&I) agents, detailing a new process to be followed with respect to the issuance and enforcement of delinquent information document requests (IDR).[20] In short, the directive provides for a very structured approach to the issuance and enforcement of IDRs and sets forth a more rigorous process which is a significant change from prior policy. The Service believes that the new procedures will lead to a more efficient and transparent examination process by reducing the instances in which a taxpayer delays in the production of requested information.

Issuing IDRs

The Service has unequivocally stated that IDRs must now be "issue focused." Examiners are required to "identify and state the issue that has led the examiner to request the information included in the IDR." Once the issue has been discussed with the taxpayer, the examiner will determine what information will be requested in the IDR. The IDR must clearly state the issue that is being considered and only request information that is relevant to the stated issue. A separate IDR should be prepared for each issue.

Examiners are required to provide a draft IDR to taxpayers. The IDR must be written using clear and concise language. The examiner must discuss the draft IDR with the taxpayer in advance of issuing a final IDR. Based on that discussion, both parties determine a reasonable due date. If an agreement cannot be reached, the examiner will set a "reasonable due date." Currently, the "default" due date for IDRs is 14–30 days, and we would expect the Service to revert to this default if an agreement cannot be reached. Therefore, it is important to enumerate any and all reasons why a 30-day response period will not be sufficient; note that it is entirely possible that an agent may seek a response date of less than 30 days. Once a response date is agreed to, examiners are not permitted to extend the deadline under any circumstances. Examiners are also required to commit to a date by which the IDR response will be reviewed and provide a response to the taxpayer regarding whether the information provided satisfies the IDR. If the taxpayer fails to provide a complete response by the agreed-upon due date, the examiner will follow the IDR enforcement process outlined below. The process is automatic in nature; the agent has no discretion regarding whether to follow these procedures.

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[18] The definition of "withholding agent" is extremely broad. For example, a person may qualify as a withholding agent even if there is no requirement to withhold a payment. If there is concern a client may qualify as a withholding agent, it may be beneficial to discuss these rules with a member of the Washington National Tax Financial Institutions and Products group.

[19] While outside the scope of this article, the Form 1042 is used by withholding agents to report tax withheld on certain income of foreign persons. It is directly related to the Form 1042-S in that the amount of withholding payments reported on each 1042-S is required to be disclosed on the Form 1042. The due date for the Form 1042 is March 15 as well.

[20] Large Business & International Directive on Information Document Request Enforcement Process, November 4, 2013, *http://www.irs.gov/Businesses/Corporations/Large-Business-and-International-Directive-on-Information-Document-Request-Enforcement-Process.*

IDR enforcement

The enforcement process involves three graduated steps: (1) a Delinquency Notice, (2) a Pre-Summons Letter, and (3) a summons. As noted above, this process is mandatory and does not allow for exceptions.

The Delinquency Notice

If a taxpayer fails to provide a complete response to an IDR within the agreed-upon time, the examiner must issue a Delinquency Notice. There are no exceptions to the issuance of the Delinquency Notice. In issuing the Delinquency Notice, the examiner must first discuss the IDR with his manager and the taxpayer to identify what is missing from the response. Next, the examiner must discuss the Delinquency Notice with the taxpayer and ensure that the taxpayer understands the next steps in the enforcement process if the information is not provided by the response date in the Delinquency Notice, which can be up to 15 days.[21] The examiner is encouraged to have this conversation the day after the response was due, but in any event no later than 10 days after the due date. The examiner is also encouraged to send the Delinquency Notice within 10 calendar days of the IDR response due date.

Pre-Summons Letter

If a taxpayer fails to provide a complete response by the due date set forth in the Delinquency Notice, the examiner will issue a Pre-Summons Letter, which is the final notice before the issuance of a summons. The examiner is required to discuss the taxpayer's failure to respond to the Delinquency Notice with his or her manager, the territory manager, and the IRS Office of Chief Counsel (IRS Counsel). Next, the territory manager will discuss the Pre-Summons Letter with the taxpayer to ensure the taxpayer understands the next steps in the enforcement process. Note that at this point, higher levels of Service management begin interacting with the taxpayer. After this discussion, the examiner will issue the Pre-Summons Letter, which must be issued within 14 calendar days after the due date of the Delinquency Notice. The examiner will also discuss the Pre-Summons Letter with IRS Counsel.

It is important to note that the Pre-Summons Letter is not issued to the direct taxpayer contact, but is sent to the contact's supervisor. Thus, it is likely that the Pre-Summons Letter will be sent to the chief financial officer (CFO), as in most companies, the head of Tax reports to the CFO. The taxpayer will have up to 10 calendar days from the date of the Pre-Summons Letter to provide a complete response.[22]

Summons

If the taxpayer does not provide a complete response after the issuance of a Pre-Summons Letter, the examiner will issue a summons, which is an administrative order to produce the requested information. The examiner will discuss the failure to respond with his or her manager, territory manager, and director of field operations (DFO) and prepare the summons. The examiner will also coordinate the issuance of the summons with IRS Counsel. If the taxpayer fails to comply with the summons, IRS Counsel may refer the summons to the Department of Justice (DOJ) for enforcement. If the DOJ seeks enforcement, the matter will be lodged in the U.S. District Court, and litigation will ensue during which the taxpayer will be required to show cause as to why it should not be required to produce the requested information. Should the District Court enforce the summons, failure to respond may constitute contempt of court.

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[21] Any due date beyond 15 days must be approved by the territory manager.

[22] A due date beyond 10 days must be approved by the director of field operations.

Practical considerations

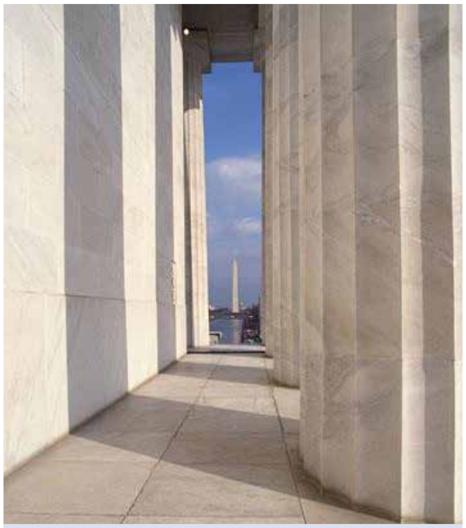
The IRS believes that this new policy will make "the IDR process as efficient and transparent as possible,"and that it will bring discipline to the examination process and increase dialogue between the Service and taxpayers.

As noted above, the new rules require a discussion regarding due dates and content of the request before the IDR is issued. As a practical matter, this should ensure that examinations are in fact more efficient and transparent. However, such efficiency is contingent upon the examiner and the taxpayer coming to an agreement as to reasonable due dates and scope of the request. Hence, there is a chance that a controversy may arise between the examiner and the taxpayer. Below are a few approaches one can take to mitigate the likelihood of such a controversy:

- Shortly after receiving a notification of examination, the taxpayer and its adviser should identify any potential issues or transactions that are likely to be of interest to the Service. The taxpayer should then identify the location of any potential relevant documents.
- Taxpayers should alert the various business units within the organization of the new IDR issuance and enforcement process. Often, the tax department relies on other departments to provide responsive information. Making those business departments aware of the new rules and consequences for late responses before a problem arises can lead to better communication within the taxpayer so that reasonable due dates can be determined and met, thus avoiding the enforcement procedures.
- Taxpayers should fully understand the draft IDR and determine how the information relates to the issue being examined by the IRS. If the taxpayer is not certain of what is being asked, then it should either propose revised language or ask the examiner to clarify, in writing, what is being requested.
- Taxpayers should also take the time to educate the Service about how the company operates and alert the Service to any unique circumstances (e.g., documents are kept abroad). It is also prudent to advise the Service of any "timing" issues that may arise (e.g., quarter-end issues).
- Taxpayers can seek to limit the scope of IDRs by being proactive and preparing a presentation or having a discussion about a particular topic (e.g., a specific transaction). This will help the Service better understand the transaction and may reduce the scope or eliminate questions that may have otherwise been asked in an IDR.
- Relationships with the examiner are much more important under the new regime. Because the agent's discretion to extend a due date is eliminated, taxpayers must be proactive before an IDR is issued to establish a reasonable due date and scope. Thus, open and continuous communication with the examiner is key to avoiding the IDR enforcement process.
- Taxpayers should not be reluctant to elevate matters within the Service. The new process is designed to include not only the examiner's manager but also the territory manager and (DFO). Because certain extensions can only be granted by a territory manager or DFO, it is important to fully explain the factors that limit the taxpayer's ability to provide the requested information in accordance with the time line provided for by the examiner.

Conclusion

The new IDR issuance and enforcement procedures are certainly a marked change from past practices and will require clear and focused communications with your examination team. The extremely limited discretion which examiners and their manager will have may lead to some difficult situations during the information-gathering process. A proactive and organized approach to your exam can help to allay some of the difficulties which may arise.



Taxpayer information protected by work product and attorney-client privileges, not policy of restraint

by Mike Dolan and Norlyn Miller – WNT

Taxpayers soon will be faced with a more rigorous policy for enforcing delinquent information document requests (IDRs) by the IRS's Large Business & International Division.[23] As a result of this new policy, it is possible that the number of delinquent IDRs will increase, and that the IRS might issue and attempt to enforce a greater number of summonses. In a much-anticipated decision, a federal district court ruled on what type of taxpayer information might (and might not) be produced in response to an IRS summons. This article reviews the court's mixed ruling and considers what it might mean for taxpayers.

Background

The IRS began an examination of Wells Fargo's income tax returns for the 2007 and 2008 tax years in October 2009. The IRS issued an IDR for certain information. Wells Fargo provided over 750 pages of tax accounting workpapers (TAWs) but did not provide all the information requested in the IDR. The IRS issued summonses to Wells Fargo and to KPMG LLP (KPMG), Wells Fargo's auditor for the 2007 and 2008 tax years. The enforceability of the summonses became the subject of litigation in the U.S. District Court for Minnesota.

Wells Fargo objected to the summons enforcement for the following reasons:

- The IRS had an improper purpose in issuing the summonses.
- Much of the information was protected by the work product privilege.
- Some documents were protected by the attorney-client privilege.
- Information sought about Wells Fargo's state and local returns and about a subsidiary's financial statements and tax returns was not relevant to the federal tax audit of Wells Fargo.

On June 4, 2013, the court issued its long-awaited order on Wells Fargo's motion to quash certain summonses relating to Wells Fargo's financial reporting and "uncertain tax positions" (UTPs), and the government's motions to enforce the summonses. In a nutshell, the court found:

- The summonses for Wells Fargo's TAWs were properly issued.
- Most of the material sought relating to the measurement and analysis of the UTPs was protected by the work product doctrine, but the identification of UTPs was not protected.
- Some documents were protected by the attorney-client privilege.
- The summonses requesting Wells Fargo's state and local TAWs and the workpapers for a subsidiary were not relevant to the examination of the Wells Fargo tax years in question.[24]

To understand the court's findings and the implications of those findings for other taxpayers struggling to comply with IRS summonses, this article next examines each finding in more detail, beginning with the enforceability of the summonses themselves, which involves the IRS's "policy of restraint."

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[23] A recent article in What's News in Tax described the new policy. Tom Greenaway and Michael Dolan, *LB&I Announces Strict Procedures to Enforce Delinquent Information Document Requests,* KPMG's What's News in Tax (Sept. 24, 2013).

[24] *Wells Fargo & Co. v. United States,* No. 10-57, 2013 WL 2444639, 112 A.F.T.R.2d 2013-5380 (D. Minn. June 4, 2013).

Reasons for summonses

Under section 7602, the IRS is given broad authority to "examine any books, papers, records or other data which may be relevant or material" to the correctness of any return, and to issue a summons to obtain the information. To enforce the summons, the IRS must show that (1) its investigation is pursuing a legitimate purpose, (2) the inquiry "may be relevant" to, that purpose, (3) the information sought is not already in the possession of the IRS, and (4) the administrative steps required by the Code have been met. This is known as the *Powell* test.[25]

The court noted that Wells Fargo's tax returns were complex, and each return for the 2007 and 2008 tax years was over 8,000 pages. The court found that the TAWs would illuminate aspects of the tax returns or, at the very least, potentially be relevant to learning more about the returns. Thus, given the complexity of the tax positions and returns, it found that the IRS was within its discretion in requesting the TAWs. It also found that because Wells Fargo had claimed tax benefits from listed transactions and engaged in other questionable tax practices in the past, the IRS had a legitimate purpose in requesting the TAWs to assist in verifying the accuracy of the tax returns.

Wells Fargo asserted that the IRS could have used other methods and information to verify the accuracy of the returns, such as the Schedule M-3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More,* and Form 8886, *Reportable Transaction Disclosure Statement.* The court found that the Schedule M-3 and the Form 8886 would not allow the IRS to identify all the tax positions that might warrant further investigation. It pointed out that under the *Powell* test, *t*he IRS only needed to establish that the TAWs were relevant to the audit, not that the requested documents were critical.

Wells Fargo also contended that the summonses should not be enforced because the IRS issued them to punish Wells Fargo, and also because the summonses violated the IRS's policy of restraint.[26] The court found that Wells Fargo did not establish that the IRS intended to punish Wells Fargo or even deter Wells Fargo through the issuance of the summonses. Further, so long as there was a legitimate purpose for issuing the summonses, such as pursuing a legitimate investigation, the existence of another purpose does not render the summons illegitimate.

Under IRS policy (called the "policy of restraint"), certain documentation held by the taxpayer or auditor is generally not to be requested by the IRS during a tax examination; this includes tax accrual workpapers.[27] In *Wells Fargo*, the court found that the requests had a legitimate purpose, thus meeting the *Powell* test, regardless of whether the requests complied with the policy of restraint. With the broad language of section 7602 allowing the IRS to examine any books and records, and the relative ease with which the government can meet standards of the *Powell* test, this case demonstrates the difficulty in establishing an improper purpose for a summons.

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[25] *Powell v. United States,* 379 U.S. 48 (1964).

[26] Under IRS policy (called the policy of restraint), certain documentation held by the taxpayer or auditor is generally not to be requested by the IRS during a tax examination; this includes audit workpapers, tax accrual workpapers, and FIN 48 workpapers, unless certain conditions are met, such as the taxpayer engaging in listed transactions.

[27] Announcement 84-46, 1984-18 I.R.B. 18; I.R.M. 4.10.20 and I.R.M. 4.10.20.3.

Work product doctrine

If a taxpayer can establish that either the work product doctrine or the attorney-client privilege apply to the requested material, the taxpayer is not required to turn over the material to the government. Wells Fargo sought the protection of the work product doctrine to deny the government the information in the TAWs. The Supreme Court established the work product doctrine in *Hickman v. Taylor*,[28] and the work product doctrine is now incorporated in Rule 26(b)(3) of the Federal Rules of Civil Procedure, which provides that "[o]rdinarily a party may not discover documents and tangible things that are *prepared in anticipation of litigation* or for trial by or for another party or its representative." (Emphasis added.)

The courts have found that there are two types of work product: "opinion work product" and "ordinary work product." Opinion work product contains the mental impressions, conclusions, opinions, or legal theories of an attorney. Opinion work product enjoys nearly absolute immunity, and can be discovered only in rare and extraordinary circumstances.

Ordinary work product is any other work product, such as raw factual information strategically selected or organized by an attorney. If ordinary work product is prepared in anticipation of litigation, it is not discoverable unless the party seeking discovery has a substantial need for the material and cannot obtain the substantial equivalent through other means.

The *Wells Fargo* court reviewed the different standards for determining when the material is considered "prepared in anticipation of litigation," established by various circuit courts. The U.S. Court of Appeals for the Fifth Circuit has applied a narrow test of requiring that the "primary motivating purpose" of creating a document be to aid in possible future litigation.[29] Other circuits have adopted a "because of" standard, first laid out by the Second Circuit,[30] that is broader and protects more documents under the work product doctrine. This test asks whether a document can fairly be said to have been prepared because of the prospect of litigation. The "because of" test is particularly helpful to taxpayers when a dual purpose exists for preparing the legal analysis (i.e., there are both business and legal purposes for the document).

In *Wells Fargo*, the district court applied the "because of" test as this is the standard set by the Eighth Circuit in *Simon v. G.D. Searle & Co.*[31] In *Simon*, information closely related to an attorney's legal thinking about an individual case—including the attorney's estimates of anticipated settlement values—was protected by the work product doctrine even if disclosed within business documents. However, certain factual data that did not reveal an attorney's legal opinions was not protected from discovery.

The UTPs

Applying the *Simon* standard, the *Wells Fargo* court found that factual information related to UTPs is not protected because it was created in the ordinary course of business and not in anticipation of litigation. The court expressed doubt that the UTPs were first identified by attorneys, but stated that the attorneys were acting more as business advisers helping to structure business transactions associated with tax positions than as attorneys offering legal advice or preparing for litigation. The court declined to accept Wells Fargo's explanation that it anticipated or prepared for litigation each time it identified a UTP. Thus, the court ruled that Wells Fargo and KPMG must disclose Wells Fargo's identification of the UTPs, the process for identifying UTPs, and other factual information surrounding the UTPs.

[28] 329 U.S. 495 (1947).

[29] Paso Co., 682 F.2d 530 (5th Cir. 1982).

[30] *United States v. Adlman,* 134 F.3d 1194 (2d Cir. 1998).

[31] 816 F.2d 397 (8th Cir. 1987).

Unless otherwise indicated, references to "section" or "sections" in this article are to the Internal Revenue Code of 1986 (the "Code"), as most recently amended, or to the U.S. Department of the Treasury regulations (the "regulations"), as most recently adopted or amended.

The TAWs

On the other hand, the court found that Wells Fargo had established that the recognition and measurement analysis reflected in the TAWs was prepared in anticipation of litigation. While the TAWs were not prepared in anticipation of litigation, the recognition and measurement analysis in them was not prepared at the beginning of the transaction, but rather appeared to have been created when Wells Fargo anticipated litigation. The analysis included settlement figures, the strengths and weaknesses of the case, and assessment of Wells Fargo's chances of prevailing in litigation. Allowing the IRS to access the recognition and measurement analysis in the TAWs would provide a window into the legal thinking of Wells Fargo's attorneys on the active litigation strategy, running counter to the purpose of the work product doctrine. The court cautioned that its ruling was limited to the taxpayer's unique circumstances; the court did not adopt the position advocated by Wells Fargo and the amicus curiae briefs that all TAWs, by their nature, are prepared in anticipation of litigation.

For the TAWs created by nonlawyers at KPMG, the court cited *Simon* for establishing that information closely related to an attorney's legal thinking—even if disclosed within business documents drafted by nonlawyers—is protected. The court determined that KPMG's analysis of the recognition and measurement steps was closely tied to the analysis of Wells Fargo's attorneys. KPMG's TAWs evaluated the analysis of Wells Fargo's attorneys and discussed whether the reserves and assessments were reasonable. Accordingly, KPMG's measurement and recognition analysis was protected by the work product privilege.

No extraordinary circumstances

The court next considered whether the IRS could overcome the work product privilege because of its need for the requested information. Since the court determined that TAWs, with the exception of the identification of the UTPs, reflect opinion work product (i.e., the mental impressions and conclusions of the attorneys), the material could only be discovered in rare and extraordinary circumstances. The court concluded the IRS did not establish any extraordinary circumstances requiring this information.

Auditor not in adversarial role

The government argued that Wells Fargo waived the work product privilege when it disclosed the TAWs to KPMG because as the taxpayer's auditor, it was in an adversarial role. The government further argued that even if an auditor were not an adversary, there are circumstances in which the auditor could be a conduit to an adversary. The court noted that KPMG was Wells Fargo's auditor for over 20 years, and there was no history of litigation or apparent conflict. KPMG testified that it had not disclosed either Wells Fargo's or KPMG's TAWs to a third party, and that it takes many steps to protect client confidentiality. The court found that KPMG was not an adversary and the privilege was not waived. The court also found that there was no more than a remote possibility of disclosure to a third party, and that was insufficient to deem a party a conduit to an adversary.

Attorney-client privilege

Wells Fargo claimed attorney-client privilege to preclude disclosure of eight e-mail documents. At least one Wells Fargo in-house attorney was a sender or recipient of each e-mail, and none was disclosed to KPMG or anyone else outside Wells Fargo. The government argued that these e-mails were not protected by the privilege because the final drafts of the TAWs were eventually disclosed to KPMG. However, the court found that the disclosure of a final draft of a document did not erase attorney-client privileges that attached to earlier versions of the document.

The court was troubled by the fact that one of the documents it reviewed appeared to contradict, or at least potentially contradict, trial testimony. The court noted that the Eighth Circuit found in another case that such a conflict would not cause waiver of the privilege.

State and local and subsidiary taws not relevant

Wells Fargo maintained that the state and local TAWs were not relevant to the federal income tax examination. The government asserted that the information about the state and local taxes may reveal inconsistencies in positions Wells Fargo took in its federal tax returns, but did not provide any examples of inconsistencies. The court found the government failed to articulate a prima facie case that the state and local TAWs may be relevant. However, the court cautioned that it was not deciding whether state or local taxes could ever be relevant to a federal tax return.

Wells Fargo's acquisition of subsidiary Wachovia closed on December 31, 2008. Wachovia filed its own separate consolidated federal income returns for 2007 and 2008. Wells Fargo argued that Wachovia's TAWs were irrelevant to the Wells Fargo 2007 and 2008 federal income tax examination. The government provided no explanation as to why Wachovia's TAWs were relevant. The court found that the government failed to state a prima facie case for disclosure of Wachovia's TAWs, and thus, Wells Fargo need not disclose the information.

Observations

- The court's holdings on the work product doctrine for dual purpose documents and materials is welcome in light of the First Circuit's holding in *U.S. v. Textron Inc.*[32] Textron elevated the business purpose of the document over its content, and the Textron court interpreted "anticipation of litigation" to mean that the document must be "for use" in litigation, which severely limits the protection of the work product doctrine.

- The government continues to argue that furnishing or sharing a work product document or material with the taxpayer's outside auditor is a waiver of the work product privilege. It is encouraging that another court has concluded that the outside auditor is not automatically an adversary.

- The years at issue were prior to the IRS's introduction of the Schedule UTP, *Uncertain Tax Position Statement,* which has been used for tax years beginning in 2010. Certain corporate taxpayers are now required to disclose UTP for which they have reserved an amount in an audited financial statement or made no reserve because of an expectation to litigate. Those taxpayers are not required to report the amount of the reserve, although they must rank reserves in order of magnitude. Taxpayers must provide a concise description of the UTP, but are not required to provide their rationale or the nature of the uncertainty. Thus, the court's holding appears to be largely in line with Schedule UTP requirements now imposed on most large corporations.

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[32] *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009). See Harve Lewis and Paul Manning, Highly Anticipated Decision in Textron Leaves Many Unresolved Matters, KPMG's What's News in Tax (Sept. 14, 2009).

- The decision sheds little light on the original IRS decision to pursue TAWs, especially when it was clear that there were no listed transactions on the returns under examination, and the company had informed the IRS that it would not amend those years to claim the benefits of any listed transactions. Under those circumstances, on its face, the IRS decision would appear inconsistent with the IRS's policy of restraint. It is equally curious as to why the IRS summonses would pursue the subsidiary and state UTP issues—both clearly outside the scope of the government's federal income tax interests in the two subject years.
- The decision reflects that the *Powell* test constitutes a relatively low bar for the IRS to meet in enforcing a summons. In the court's view, that bar was not affected by the IRS not following its long-standing policy of restraint.
- Given the apparent ease with which the original policy of restraint was overcome (or ignored), there is concern about future circumstances in which the IRS or the Department of Justice might decide to ignore the policy because it believes UTP-related TAW information is of some value to an ongoing examination.
- While most will view the *Wells Fargo* decision as a significant taxpayer win, it is important to keep its overall significance in perspective. Like most decisions, the taxpayer's specific context underpins key elements of the court's reasoning. Wells Fargo's facts, while not unique, are likely different than those of many other taxpayers. For one thing, there is a clear history of tax controversy and litigation between the government and Wells Fargo. Consequently, the UTP-related activities undertaken by Wells Fargo might have been more credibly viewed as "in anticipation of litigation" than might be the case for taxpayers in different circumstances. Similarly, Wells Fargo significantly involves its controversy group attorneys early in the UTP evaluation and measurement process, increasing the likelihood that its organization and processes may more likely support a claim of privilege.

Outlook

It is now up to the parties to appeal to the Eighth Circuit. In *Textron*, the government first lost in the district court and initially at the circuit court, but won in an en banc decision by the First Circuit. Given the IRS's adoption of the UTP regime for years 2010 and beyond, a government appeal might lead to taxpayer apprehension about the extent to which they can or should rely on the IRS's reaffirmation of the policy of restraint that accompanied the introduction of the Schedule UTP.

Treaty and Intergovernmental Agreement update

by Anthony Marsicovetere

As mentioned in our previous quarterly newsletter, a number of pending U.S. tax treaties and protocols to existing tax treaties have stalled with the U.S. Senate. In late 2011, Senator Rand Paul, R-Ky, placed a hold on Senate floor consideration of the pending Swiss and Luxembourg protocols as well as the pending treaty with Hungary. According to tax analysts, various sources stated Senator Paul placed this hold based on his objection to the treaty information sharing provisions contained in these agreements. These agreements contain updated information exchange provisions that implement the Organization for Economic Cooperation and Development standard on information exchange.

In 2013, the United States concluded 19 Intergovernmental Agreements (IGAs) including IGAs with the following countries: Switzerland, Norway, Spain, Germany, Japan, France, Costa Rica, the Cayman Islands, Bermuda, Malta, the Netherlands, Jersey, Guernsey, Mauritius, and the Isle of Man. An IGA with Italy has been initiated. **A number of countries continue to be in the process of negotiating their IGAs** and there are several more that have been agreed to and are going through the administrative process (e.g., translation) prior to the official signing.

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